

DOW THEORY LETTERS INC.

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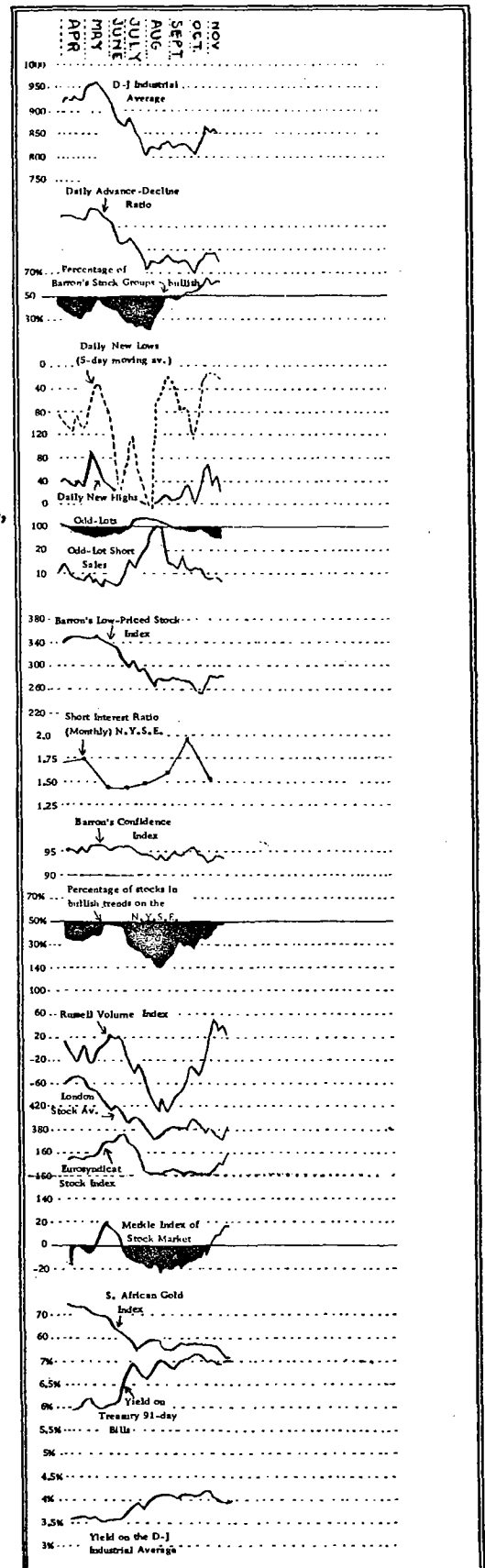
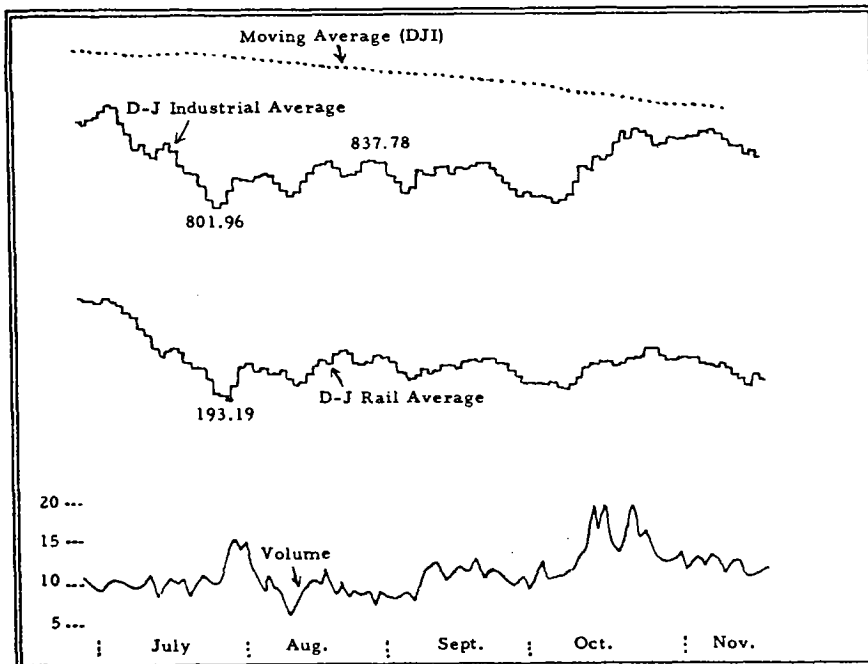
November 21, 1969

Letter 445

THE MARKET: In his latest Monetary Report, Alden Wells notes that following World War II President Truman raised Government spending 100%. President Eisenhower then boosted Government spending 30%, followed by the 20% rise under President Kennedy. More recently President Johnson raised Government spending 75%. In glancing over the current Nixon budget of roughly \$200 billion, I note a rather horrendous fact. Around \$80 billion of the budget will go to defense and approximately \$19 billion will be spent for interest on the national debt. Thus one half of the entire \$200 billion Federal budget can be placed in the "waste" category. That the U.S., this year, will spend \$100 billion on defense and interest on debt is one of the sickest, bleakest and most discouraging facts now facing the American people. In coming years historians may look back on this single fact as the sign of a diseased society. I am telling my readers that you don't have to "look back." You can study the \$200 billion "garbage budget" right now.

One of the fascinating things about markets is that they cut through rumors, gossip, fantasies and dreams. For instance, for weeks now (actually for months) various experts have been telling us that the peak in interest rates has passed. This may well be true and no one can disprove it at this time. But last week the yield on the Treasury 91-day bills jumped to 7.15%, suspiciously close to the record high established earlier in 1969. On November 12 the bond market trembled as a subsidiary of the mighty Bell system (South Central Bell Telephone) sold \$125 million of their Aaa bonds at an all-time record interest rate for Bell of 8.53%. At the same time the bellwether Treasury bond, the 4.25% of 1987-92 sank to a record low of 70 20/32's, while the yield on Barron's 10 highest-grade bonds rose to a record 7.45%.

On November 13 a rumor ran through Wall Street to the effect that a major bank was about to raise its prime rate. Perhaps in response to this rumor, the Dow Industrial Average sank below the 850 level for the first time since October 29.



Page 2 Those of my subscribers who follow the market carefully were undoubtedly less impressed with the prime rate rumor than by the fact that a long series of daily divergences in the Averages preceded the November 10 Industrial recovery high of 863.05 on the Dow.

During the 16 trading days of October 20 to November 10, the Rails and Industrials diverged (moved in opposite directions) no less than on 11 closings. When the Averages disagree to this extent, it often implies an impending change in direction.

From the standpoint of non-confirmations, the recent action of the Averages has also been interesting (see chart 1). Industrials struck a recovery high of 862.26 on October 24. This peak was unconfirmed by Rails. A few days later, on October 28, Rails pushed to a recovery high of 202.45, and this time Industrials failed to confirm. Finally, on November 10 Industrials barely edged to another recovery high of 863.05, and this time Rails were actually heading down. On November 14 weakness was confirmed by the daily new high low figures, which showed 9 highs and 31 lows for the day, first reversal of this index since October 13. By November 17 the Industrial Average had dropped below the minor decline low of October 29 (below 848.34), thereby establishing the first downward zig-zag in the Industrial price structure.

HOW WILL IT HAPPEN? I study the bank liquidity charts, I watch the trend of interest rates, I stare at the long-term pattern of the D-J Averages, I read inciteful interviews i.e. the Haas, Storey, Lekachman interview in Barron's, and I wonder how much longer this market can resist going over the edge of the precipice. Everyone appears to be remarkably calm, and in all my reading I have come to one firm conclusion. With very few exceptions people are either complacent or only thinking of trouble within the context of market and economic action as it occurred over the past 15 years.

In other words, they are failing to comprehend that the recessions of 1953, 1957 and 1960 were simply pauses within the greatest bull market in history. But this time it is different! The Industrial Average has refused for almost four years to better its bull market high. The Utility and Bond Averages have broken down badly, the Rails are only a handful of points above their 1966 bear market low, and a primary bear market is on. True, the bear has been lulled to sleep by the optimistic words of economists and politicians, the public has been soothed by speculative activity and their own wishful thoughts. Even President Nixon and his leading advisors are singularly unaware of the major differences which exist now and when Nixon was Eisenhower's Vice President.

All in all, I would say that the only real public hint of a primary bear market building appeared in the Barron's interview of November 10 and 17. Barron's must be commended for having the courage to present this type of message, although my personal belief is that not one in a hundred investors will take to heart what the Storey, Lekachman, Haas interview was really telling us.

I cannot say whether the market itself, in its mysterious subconsciousness, will signal the end by simply plunging through the 1966 lows. Or whether business will start leveling off, then sinking despite everything that will probably be done to stop the descent. Or whether some startling corporate failure or perhaps a credit crisis will bring the bear out into the open for all to see.

But I do think that we are drawing close, very close to the end of an illusion. My guess is that between here and early 1970 the market and the economy will be in very serious trouble, the money markets will be chaotic, Vietnam will be a frightful pressure spot, and the realization that this time "it is indeed different" will permeate the consciousness of all who are invested or have anything to do with stocks and bonds.

UTILITIES AND BONDS: Long-time subscribers know that I give a good deal of credence to the trend of the two "money-rate" averages, the D-J Utility and Bond Averages. Since we are particularly concerned with the primary trend at this time, I felt that a long-term picture of these two Averages was warranted.

As seen on these monthly charts (page 3), both Utilities and Bonds are still in primary downtrends. The low for the Utility Averages was 109.98, recorded on October 9, 1969. Utilities rallied during the rest of October, but in November they stalled, and as of this writing the Utilities are 9 points above their 1969 low. Note, however, that the Utility Average was the first of the common stock Averages to penetrate its 1966 bear market low.

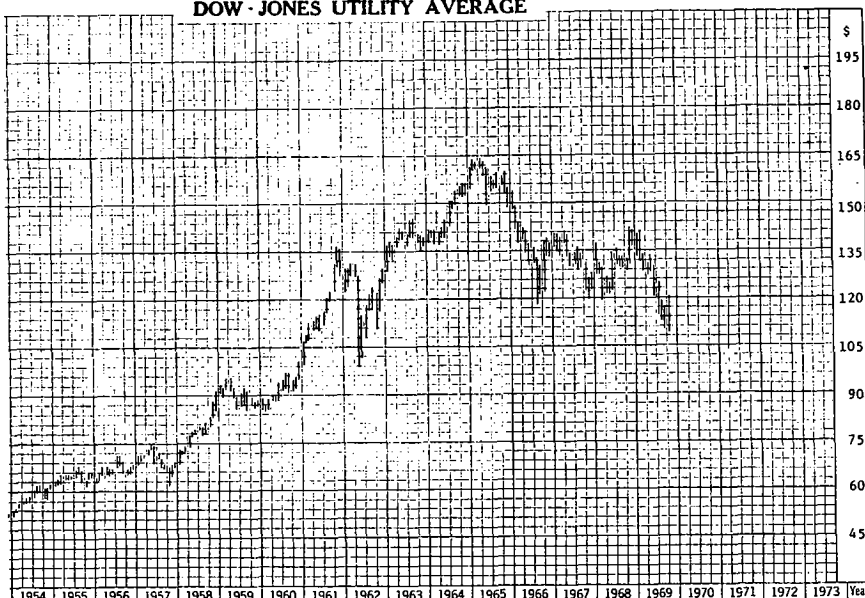
The Bond Average struck its 1969 low on October 9 at 70.31. Since then it rallied a few points, and as of this writing it has sagged to within less than a point of its 1969 low. The D-J 40 Bond Average has not only violated its 1966 low, but it is currently at its lowest level since 1933.

Although playing no part in Dow's Theory, I consider both of these Averages important since they are not only subject in direction to the primary trend but they often lead the Industrial and Rail Averages. The rating on both the Utility and Bond

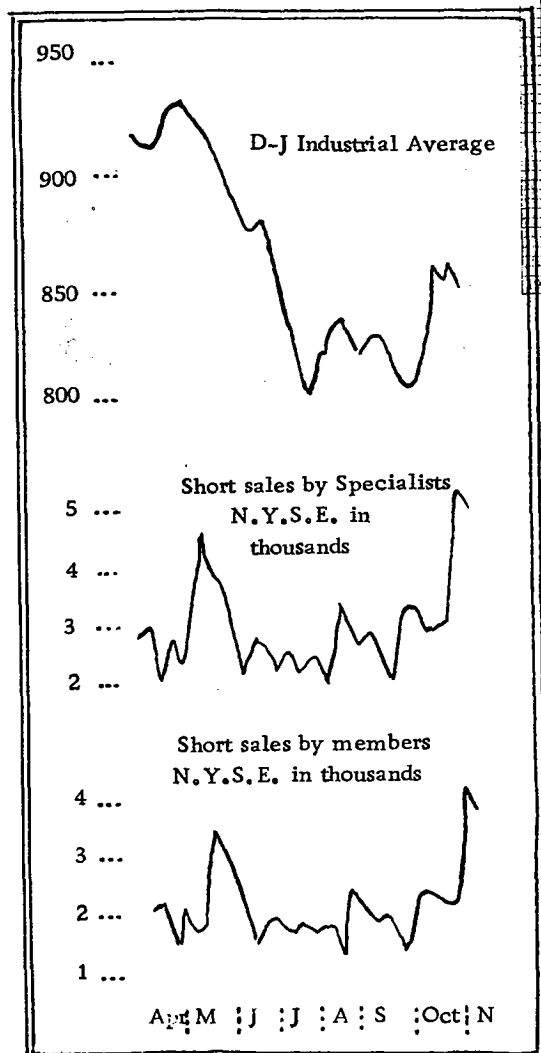
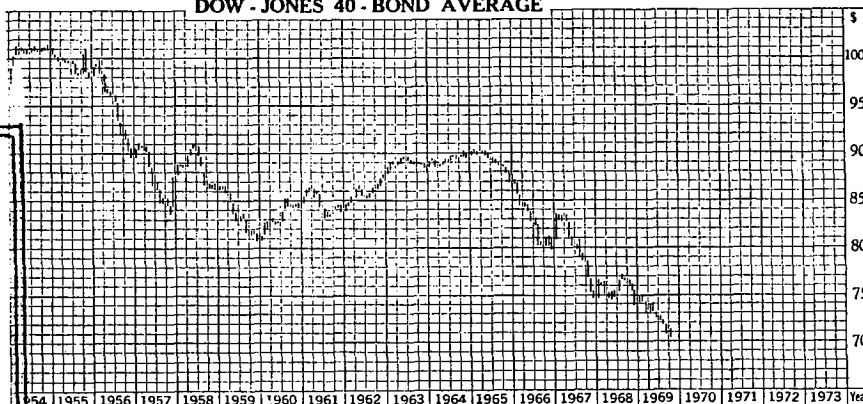
Averages must be considered "bearish," and in the past when this has been true the "investment climate" for the market has been unfavorable. (Charts courtesy of M.C. Horsey, Salisbury, Md. 21801).

SPECIALISTS AND MEMBERS: Short selling tends to be a pretty professional affair. Normally, for instance, specialists on the N.Y. S.E. tend to produce about half the short selling on the Exchange. At certain times specialists' short selling may jump as high as 70% of all N.Y.S.E. short sales, at other times it sinks to minimal proportions. A second source of short selling is from member firms on the N.Y.S.E., and this short selling tends to follow the trend of

DOW - JONES UTILITY AVERAGE



DOW - JONES 40 - BOND AVERAGE



the specialists' short sales.

The other end of the short sales picture consists of the short selling from the "public" or the non-professionals. In general, extremes in public short selling tends to be wrong, and this is particularly true within a primary bull market. In other words, when the short interest builds to a relatively high level within a primary bull trend, the technical condition of the market is invariably strengthening. On the other hand, an abnormally low short interest within a bull market weakens the technical condition.

Within a primary bear market such as now, the short interest is not as crucial. It should be remembered that during a primary bear market the short seller is invested with the primary trend. Thus, for instance, in early 1931, with a relatively large short interest of 5 million (very large in those days) the market still collapsed and produced frightful losses throughout the year.

On a short-term basis, the trend of member and specialist shorting is of use in gauging the technical situation within either a bull or bear market. For unlike the short selling of the public (which is largely emotional), the specialist and member short selling is based on a good deal of inside

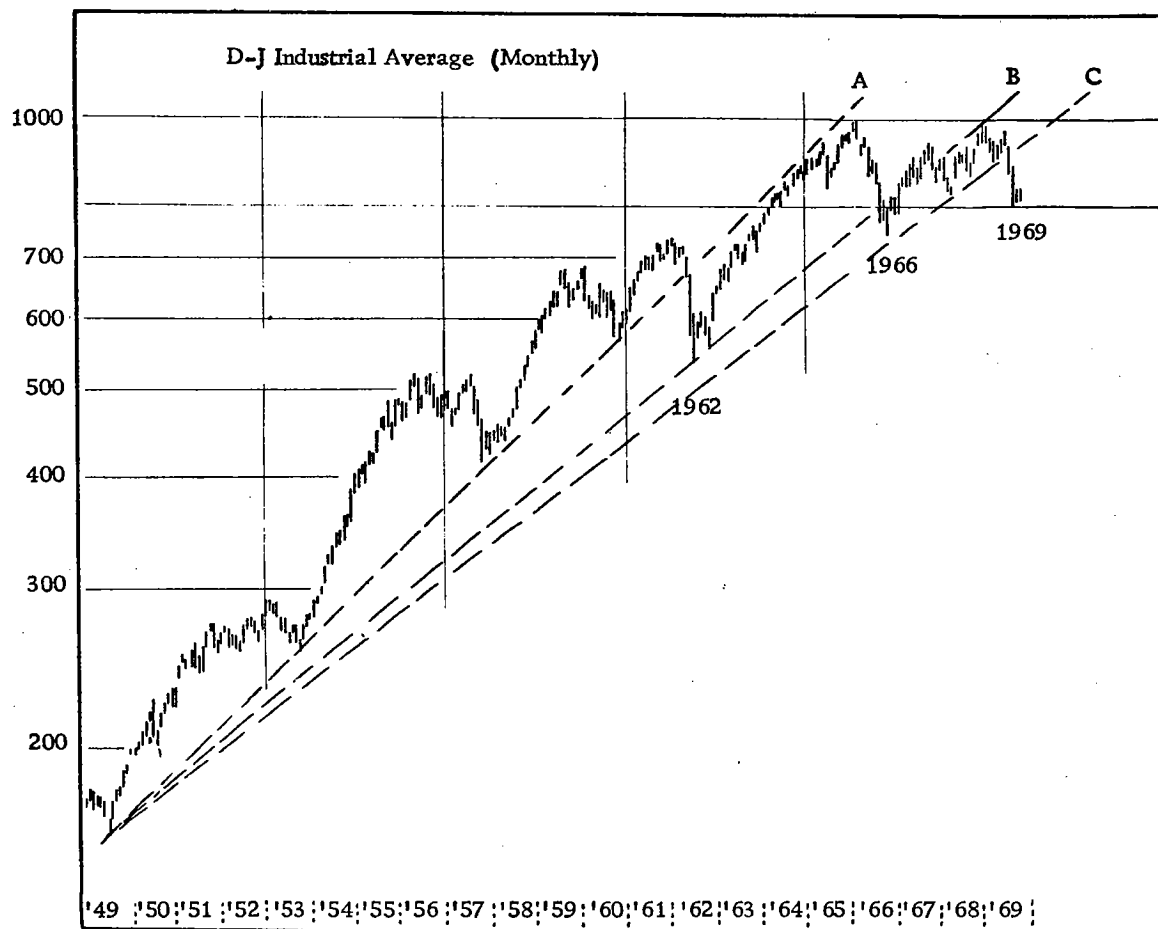
Page 4 knowledge plus (in the case of specialists) a knowledge of what buy and sell orders are on the "books." Obviously, if specialists' books are building up with sell orders and buy orders are thinning out, the technical situation is growing precarious, and at such times specialized knowledge can come in very handy.

Although members' short sales (weekly) have been reported by Barron's for years, it was only last April that Barron's started reporting weekly short sales of N.Y.S.E. specialists. Ordinarily, there is a three-week lag in reporting the figures, but I believe these figures are nevertheless useful.

I have included a chart (page 3) showing specialist and member short selling (in thousands of shares) together with weekly closings of the Dow from April, 1969 to the present. I have not allowed for the three-week lag, but have plotted all three figures, just as they appear in Barron's. I figured that there could well be a two to three week lag between what the specialists and members "foresee" and what ultimately materializes in the market.

Note on the chart that there was a bulge in professional short selling during early May, and this was followed by the sharp decline in the Dow during late-May, June and July. Recent figures show another and even sharper bulge in professional short selling during the actual weeks ending October 17 and 24. In other words, something occurred during mid and late October which caused professionals to step up their short sales substantially.

On November 10 the Industrial Average struck a peak of 863.05. The decline since then would seem to be a reflection of the technical weakness which the professionals saw in mid-October. To me, it is interesting that professionals were boosting their short selling sharply in mid-October at the same time that the total short interest on the N.Y.S.E. (for mid-September to mid-October) sustained a whopping drop of 1.7 million shares. The inference is that the public was reducing their short position while the professionals were upping their own short position, never a good omen.



CHANGES: I have always been fascinated by semi-logarithmic charts. I suppose the reason is that semi-logarithmic or "ratio" charts measure the rate of change. Ratio charts are scaled so that if a price movement continues at a perfectly steady rate, that movement will appear as a perfectly straight line on the chart. In actuality, that straight line will be a trendline. Any variation from the trendline will immediately imply a different or changed rate of advance or decline.

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I have shown the D-J Industrial Average from June, 1949 (when the 1949-1966 bull market began) to the present. From 1949 to 1962 the rate of growth in the Dow was measured by trendline "A" on the chart (page 4). In 1962 this initial growth rate was ruptured, and I then drew a second shallower trendline ("B") which measured the rate of growth through the entire period from 1949 to 1966.

At the 1966 lows the "B" rate of growth was broken, but for a short period during 1967 the Industrial Average again climbed above trendline B, thus indicating that the Dow was attempting to hold the "B" growth rate. During 1968, however, the Dow again sank below trendline B, and during the peak of the 1968 rally it was notable that the Dow was unable to attain the B growth rate.

A third trendline marked "C" was drawn, this time connecting the 1949 low with the 1966 and 1968 bottoms. For a while it seemed as if the Dow meant to hold at the new and shallower "C" growth rate. But the 1969 decline took the Dow decisively below the "C" trendline.

What is causing the Dow to establish increasingly shallow rates of growth? As I see it, each new, shallower rate of growth serves to discount and reflect a mounting mass of problems for stocks and the economy. For instance, the rise from 1949 to 1961 appeared strong and relentless. The "A" trendline was tested four times, and each time the Dow surged above this initial trendline. The surge from the second or "B" trendline was brought on by a huge infusion of money and inflation. The explosion from the 1962 bottom was highly speculative. When it broke in 1966, the market woke up to the tune of endless new and severe problems brought on my loss of gold stock, inflation, high interest rates, disastrous balance-of-payments, spiraling consumer and manufacturer prices.

Note the difference in the quality of the recovery since the 1966 low. Following 1966, for the first time, the Dow was unable to establish a new high. In 1968 the Dow barely pushed above the 1967 high, then sagged and plunged below the 1968 low. This in itself was a different performance than any since 1949.

I recommend to all subscribers a careful reading of the interview with eight top economists which appeared in the pages of Time Magazine's November 14 issue. These eight men are highly qualified and obviously sincere economists. Each of them boasts a large following among businessmen and Government planners. The thing that I found so interesting was the frank confusion, the anxiety, the honest differences of opinion. Some thought the economy was already in recession, others saw a danger of too much boom in 1970, still others advocated keeping tight monetary reins while a few insisted that a continuation of the current monetary policy would bring on a severe recession in 1969.

The point, as I see it, is that perplexity is now the order of the day. Honest men are simply "at sea" as to what to expect in 1970 and beyond, or for that matter, they are confused about what is happening now.

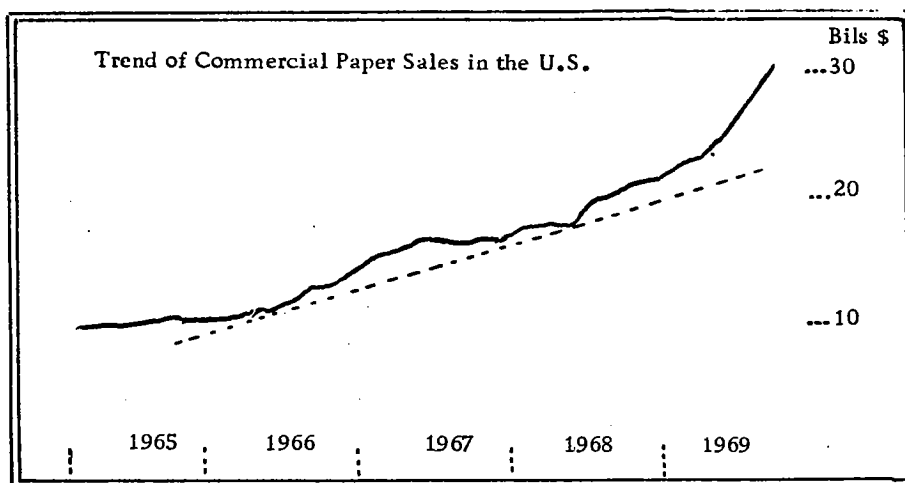
Meanwhile, the Dow has "topped out" but is unwilling to collapse. The picture on the chart since 1966 is one of indecisiveness and confusion. For three years the Dow has fluctuated within the confines of the 1966 limits. What would I consider a definite statement by the Dow? I would consider a plunge below the 1966 low of 744.32 as a forecast of trouble. I would also consider such a movement as a full reversal or cancelling of all "growth rates" since 1949. A penetration of the 1966 low would imply a contraction rate, a full turnabout in the three growth rates or trendlines which have held sway since 1949.

COMMERCIAL PAPER: In the last letter I showed how banks, in the wake of a massive drop in their certificates of deposit, had turned to commercial paper as a source of money. The collapse in C/D's has been brought on by the fact that the Government's regulation Q limits the ceiling which commercial banks can pay for C/D's. That limit is 6.25%, a rate which is far below that required to bring money into the banks. So the next place to go was to commercial paper, which can be issued at any rate of interest the issuer desires.

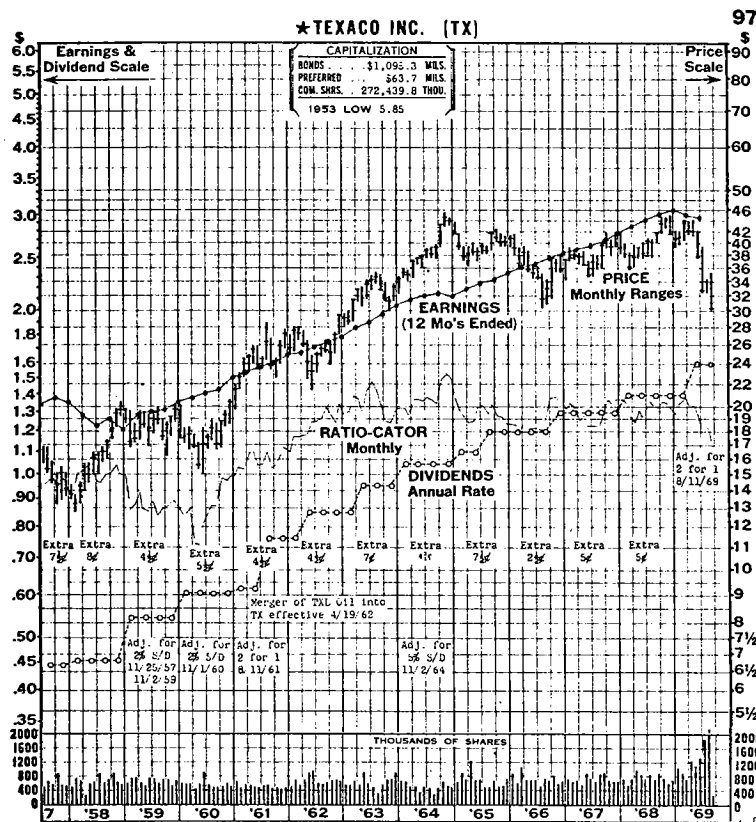
On December 1 the Federal Reserve Board will get the power to apply regulation Q to commercial paper rates (at least commercial paper issued by commercial banks). Even if the ceiling of 6.25% on regulation Q is raised, this is going to mean a further squeeze on the banks.

The Eurodollar market is already feeling the effect of the coming new squeeze. Following Eurodollar rates as high as 12%, Eurodollar rates broke down to the 9% level a few weeks ago. On November 17 the Eurodollar rate rose over 10% again.

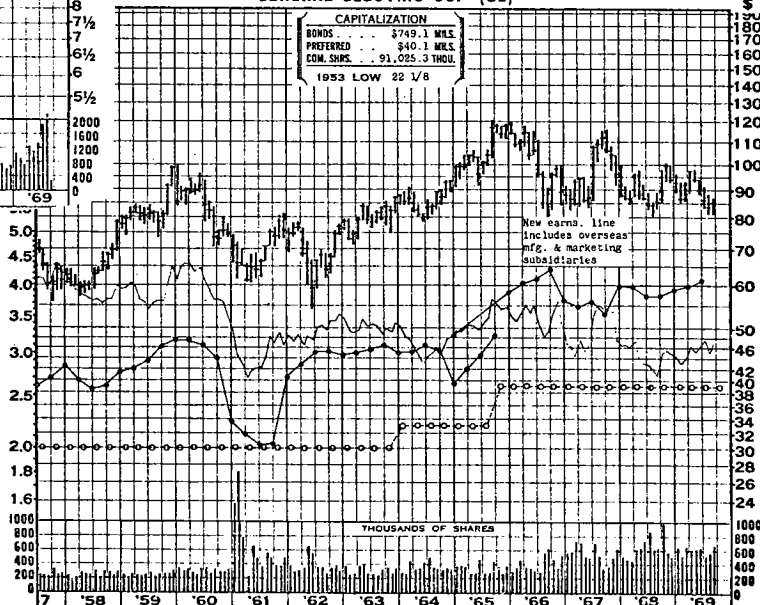
chart showing just how important commercial paper is in the U.S. Here we see the trend of total commercial paper outstanding in the U.S. over the past five years. I have drawn a trend-line showing through the end of 1965 and through early 1968. Since mid-1968 commercial paper sales have skyrocketed. During 1969 commercial paper sales rose at an annual increase of 50%! This is the next area of trouble and confusion in the money markets. And it's a leak which the Federal Reserve considers annoying in the fight against inflation.



STOCKS: I draw attention to a few of the biggest of the Dow stocks. Texaco, at 30, has broken its 1966 bear market low and retreated to its 1963 range. This is the first serious breakdown in Texaco since the early 1940's. General Electric, now on strike, is flirting with the 80 level. Any break below 80, a support zone for three years, would be ominously bearish for the world's leading electric equipment stock. (Charts courtesy of Securities Research, 208 Newbury St., Boston, Mass. 02116).



★ GENERAL ELECTRIC CO. (GE)



NOTICE: On Saturday, November 22, we are moving this office 15 miles northwest to La Jolla (La Jolla is a suburb of San Diego, and it is where I live). The new address change will be posted in the next Letter. La Jolla, in my opinion, is one of the prettiest spots in the U.S. A subscriber told me, "Russell, if you can't get optimistic in La Jolla you're hopeless." In time and when the situation warrants, I intend to become bullish. Perhaps La Jolla, "The Jewel of the Pacific" as it is called here, will make me more so.